

To make money on the stock market, think outside the box

Things aren't always what they appear to be — in fact, in the investment world, they seldom are.

After the worst year in a decade, the stock market looked like its former self in January, with the technology index roaring back 24 percent, leaving the more staid industrial indexes' return of 3 percent in the dust.

Still, 3 percent in a month ain't all that bad, unless you try the unfortunate exercise of figuring, well that would be 3 percent times 12 months equals ?

How do investors get a grip on what is really going on in the market? Look at interest rates, maybe. The Federal Reserve Bank, august keepers of the nation's money supply, took a bold step to help stave off a recession by cutting



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Real Money

interest rates a full 1 percent within the span of a single month. By golly, that ought to set the market humming.

It is a little hard to remember so far back as two years ago — irrelevant history in some investors' eyes — to when the Fed raised

interest rates six times in order to cool an "over-exuberant" market.

Did it have much effect? Stocks continued on their upward spiral in spite of the central bank's efforts to cool down the economy. The economic slowdown that the markets started seeing this past fall, which is likely to continue into this coming summer, is an indirect consequence of the Fed's heavy-handed actions in 1999.

The recent cuts in interest rates may produce only a temporary underpinning for most stock prices.

Certain sectors, such as retailing and financials, stand to benefit on an ongoing basis from easier money policies.

Investors ought to be aware of the very real possibility of a "W" shaped downturn, one that has a second and more serious pullback ahead. The U.S. economy has already slowed by more than 50 percent, from a growth rate of more than 5 percent last year to well under 2 percent today.

It may be that the ability of the government to change the climate for business spending is so indirect, with such a long lead time, that we could see zero growth in the economy for the first time in more than five years in spite of the recent interest-rate cuts.

What does this mean for you?

Real money is made when investors discern long-term trends and have the patience and discipline to stick with a fundamentally sound approach that benefits from these trends.

Building wealth through stocks requires an understanding of a few basic tenets. One of these is that economies and companies have cycles.

Different kinds of companies thrive during various phases of the economic cycle, and some companies react much more successfully to changing markets for their products than their competitors.

For example, retailers did terribly when interest rates were climbing. They stand to benefit from the Fed's current actions as noted above. But even within the retailing industry, one finds a variety of business models. On the one hand, there are firms such as Montgomery Ward, which refused to change plans for its store locations and therefore did not see fit to spend capital on expanding to the suburbs, thus setting the stage for its demise. On the other side of the spectrum, you find Amazon.com, which some people thought was immune to the reality of business cycles because they appeared to have no bricks and mortar to worry about becoming

dated. In fact, Amazon recently laid off 1,300 employees and is closing two distribution sites. People and warehouses turn out to be just as important for e-business as for any other kind of retail endeavor.

In between the old economy and the new stands a hybrid kind of entrepreneurial organization. It is a lean, mean fighting machine on the outside with warm and caring service people within. There are several companies in the retailing area that fit this description: Target and Costco are among them. Every industry will have its big winners and losers in the upcoming decade. We think it will be harder to make money just by "being in the market." People who stayed with great names like Xerox, General Motors and Pacific Gas and Electric have been terribly disappointed. It is likely that the stock market will now require closer scrutiny and vigilance.

Our firm makes a point to consider what we call "contrary indicators." We try to be aware of what the general investing public is doing by tracking the American Association of Individual Investors survey, which shows what the "informed" non-professional investor is doing. The retail option buyers' ratio of worthless expiration tells us what the more aggressive individuals are doing in the market and if these trader types are strongly optimistic or pessimistic. On CNBC, viewers call in questions which we take as signs of what the general public is hearing and seeing in the electronic media, as far as buying stock is concerned.

Most people make their investment decisions based on the emotions of fear (bearishness) or greed (bullishness). These financial habits come primarily from a basic and natural switch in our consciousness: the fight or flight instinct. These fear or greed signals captivate most people's judgment, and they are therefore compelled to react to the market rather than anticipating it. This is why when things are good, everyone wants in.

But I ask you, when everyone is in, who is left to do more buying? Conversely, when most people look at markets that are down, they decide to sell. When enough people sell, the number of nervous sellers left goes down, thus preparing for the next market increase.

So, where are we today and what should you do with your stocks? On the cautious side, beware of companies that have gone up a lot in a short amount of time. Qualcomm, JDS Uniphase and a host of others fall into this category. It's not that these aren't great companies with wonderful futures — it's just that they are still too expensive. Just because a company has gone down doesn't mean it doesn't deserve to go down more until it forms what we call a market "bottom." This is where the technical factors favor a halt to the stock price slide.

Take a moment to think about what a reasonable rate of return might be for your portfolio and for the companies in your account. Is it 10 percent, 12 percent, maybe even 15 percent per year? If it's more, please ignore the rest of this article and head on out to the casinos. We look at the rate of growth in a company's sales and how solid are its profits. If these are sustainable, then we consider investing in it. We look primarily at a company's management, their markets, and then their financial statements. There really is no substitute for rigorous analysis and personal experience. Go out

and look for yourself at what people are using and what is next on their wish list. This should guide you in deciding what to keep and what to sell. It is important to have a clear philosophy so as not to be distracted into following the crowd.

Certain aspects of the economy are not going away. Pharmaceuticals, finance and telecommunications all remain mainstays of our economy. There are some tremendous bargains in the telecom area, which was beaten up last year. Don't stay with the tried and true; consider diversification into some great industrial companies that have adapted the latest in technology but who make great profits even in difficult economic climates. Pfizer, Citigroup, and Global Crossing are among the best in these particular industrial groups.

People will always shop for quality at reasonable prices. The energy business is cyclical, so think hard about buying into oil stocks when there still is a glut of supply on world markets. Look where other people dare not go. Who out there is thinking that Japan might be a good place to start putting some money? Investors have given up on the Japanese stock market and this means there are wonderful opportunities there. After 10 years of economic mismanagement, I feel that Japan is poised to grow in new and intriguing ways. Why? Corporate income taxes are about to be reduced there and the destructive pattern of inbred cross ownership of companies and deceptive accounting practices are being unwound. We use a stock called "WEBS-Japan," which is a basket of the top companies as a cost-effective way to begin investing in Japan.

Probably the next most important factor to keep in mind when buying stocks is the time frame you have for your investments. No one buys a house thinking they are going to get rich because the neighborhood is going to get better over the next three to six months. We buy houses (and stock) because we

are comfortable knowing that what we own is useful, of high quality and that we haven't paid too much to get into it in the first place. Looking for bargains isn't a bad way to go but don't buy just because something is cheap.

In order to be successful, avoiding the pitfalls of following general market sentiment is crucial as is having the right time frame in mind. More about this in my next article which appears on the second Tuesday of each month. In the end, try not to worry about things you can't control, like interest rate changes and company earnings shortfalls. If you know how to build a diversified portfolio on which you manage not to pay much tax, you will be well on your way to financial security. After all, isn't this what it's all about?

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